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The Economy: Limited Visibility

IT now appears that "real" (i.e., inflation-adjusted) GNP increased in the third quarter, and that the gains were fairly widespread. But, in the two-handed world of economics, this development is subject to sharply differing interpretations.

On the one hand, a case can be made that all of the decline in the second quarter was due to such special factors as the gas lines and the truckers' strike, and that the expansion which began in early 1975 is still in progress, albeit at a reduced pace. On the other hand, since economic growth in the third quarter probably left real output below its first-quarter level, it can reasonably be argued that the economy is still in a recession which began last spring. Policymakers are having to face not only these uncertainties on the domestic front but an international situation which, in the opening days of October, included renewed selling pressures on the dollar and surging prices in the markets for gold and other metals.

Evidence of a weakening trend in economic activity persists. The growth in industrial production declined from 8.3% in the twelve months ended February to 2% in the twelve months ended August. Similarly, the rate of growth of retail sales fell from 13.1% to 8.1%, while personal income growth tapered off from 13.5% to 11.3%.

The erosion in personal income (which was even more pronounced in real terms due to the acceleration of inflation), coupled with the heavy burden of household debt, should depress consumption expenditures in the months ahead. Moreover, continued weakness in industrial production seems assured by the decisions of do-

mestic auto manufacturers to cut fourth-quarter output to the lowest level for that quarter since the last recession.

Countering these weaknesses, however, has been the continued strength in housing. Not only did starts remain at close to the 1.8-million annual rate in August, but permits actually rose slightly. At least for the near term, financing for new housing should remain available. For although the inflow of funds to the thrift institutions has diminished sharply in recent months (mutual savings banks have experienced net outflows), commitments for future mortgage lending by savings and loans as of the end of August was virtually at the same level as a year earlier.

The implications of the recent behavior of inventories for the economic outlook are more ambiguous. Manufacturers' and trade inventories jumped by 1.9% in July, the largest monthly gain since September 1974—hardly a reassuring comparison. But the decline in industrial production in August should have helped to keep inventories reasonably in line with sales and thus diminished the chances of a sharp liquidation of unwanted inventories in the fourth quarter. What is more worrisome is the possibility that the recent spurt in commodity prices will induce speculative inventory buying in anticipation of worsening inflation.

Moving cautiously

The actions of the Fed in recent weeks have in many ways mirrored these conflicting economic signals. Under ordinary circumstances, the Fed would routinely raise the discount rate in response to a bulge in member bank borrowing. But the latest increase in the discount rate —to an historic 11%—was approved by only a 4-3 vote of the Board of Governors, despite the sharp rise in bank borrowings which preceded it. This sign of disagreement among monetary policymakers touched off speculation by financial market participants that the Fed might be nearing the end of its series of tightening moves. Indeed, the subsequent increases in the Federal funds rate to the 11½%-11¾% range came in smaller increments than the increases in August.

At the heart of the Fed's dilemma are the lags which exist in the impact of monetary policy on output and inflation. If the Fed continues to increase the funds rate until there is clear evidence of a deceleration in prices, it runs the risk of seriously aggravating an already weak economic situation. But were the Fed to begin to ease now in anticipation of further economic weakness, it would run the danger of worsening the international position of the dollar. For in the absence of more conclusive evidence of a continuing economic downturn, foreign exchange markets might not be convinced that such a move toward ease was justified.

It would, therefore, not be surprising to see the Fed avoiding sharp moves in either direction. Given the international pressures on the dollar and the continuing dismal news on the inflation front—the CPI rose at a 13.4% annual rate in August and producer prices soared at an 18% pace in September—the Fed will likely feel constrained to maintain interest rates near their current high levels. However, there will probably be ample counsel both from within and from outside the Federal Reserve System against pushing rates still higher. Similarly, there will surely be voices urging against even the most tentative moves toward ease until firmer evidence of a recession is available. Against the background of current uncertainties, and in view of the risks associated with any policy actions, caution on the part of the Fed would be understandable.

Those Gas Lines—A Postmortem

MOTORISTS in many parts of the nation last May and June fumed and fretted in exasperatingly long gasoline lines. "Why the pile-up at the pumps?" motorists demanded angrily. Answers at the time did little to dispel confusion. Now, with the availability of first-half data on oil production, consumption, and inventories, some conclusions can be drawn.

What the numbers reveal is a paradox: despite all the furor, the oil shortage was relatively small and short-lived. Indeed, looking at charts of worldwide trends in oil production and inventories (pages 4 and 5) it is difficult to discern that there was any real shortage.

Blame-laying by Americans at the time singled out the oil companies, OPEC, and the U.S. Department of Energy. The evidence suggests, however, that the basic system under which petroleum products are distributed in the U.S.—regulated by government allocation and price controls—may have been at the heart of the problem.

During the first half of 1978, demand for crude oil was depressed as refiners and distributors in consuming countries worked off the heavy inventories that had been built up during 1977. Those inventories were in large part the result of hedging against a yearend-1977 OPEC price increase that in fact never occurred. In early 1978, OPEC nations cut back production, and prices in spot markets were generally weak. By autumn of last year, however, inventories had been reduced significantly, and the continuing upward trend in world oil consumption was beginning to trigger increased production.

In the fourth quarter of the year, the developing political turmoil in Iran, OPEC's second largest producer, began to take its toll on oil production in that country. From almost 6 million barrels per day (bpd) in the third quarter, Iranian output fell to 3.8 million bpd in the fourth quarter and dropped further to just over 1 million bpd in the first quarter of 1979. This decline, however, was offset by increased production in other OPEC countries (most notably Saudi Arabia but including also Nigeria, Iraq, and Kuwait). With a rising trend in production outside of OPEC as well, total world oil production in the first quarter of 1979, despite events in Iran, was actually slightly above the somewhat depressed average production level of 1978.

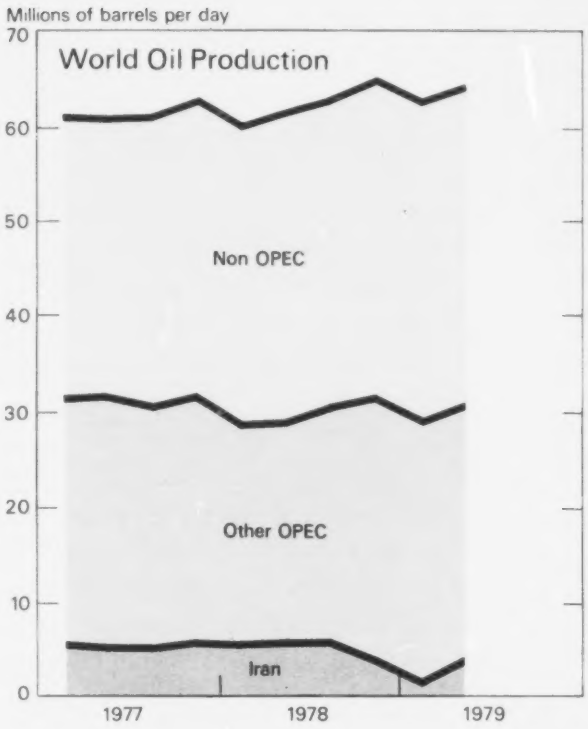
In the second quarter, Iranian production recovered to almost 4 million bpd, but this was partially offset by a 1 million bpd production cutback by Saudi Arabia. Worldwide production rose about 2 million bpd and was running about 3.6% above the rate of production in 1978. In the third quarter, the production cutback by Saudi Arabia was reversed and output rose further.

As is now clear from the production statistics, the relatively low production level in the first quarter of this year was inadequate to meet the existing upward trend in world oil consumption, especially in light of the very cold winter in Europe which boosted demand for heating oil and the generally strong economic growth of industrial countries. Inventories of oil in the major importing countries fell sharply, but the decline was only several hundred thousand barrels per day more than is normal at that time of year (chart on page 5). The figures suggest that production was running below consumption, but that the shortfall was only a modest one. In the second quarter and, apparently, also in the third quarter, production seems to have been ade-

quate to meet consumption requirements, particularly when the impact of the higher OPEC prices on demand is considered. The general picture indicated by the figures is one of a relatively minor and temporary shortfall in worldwide oil production.

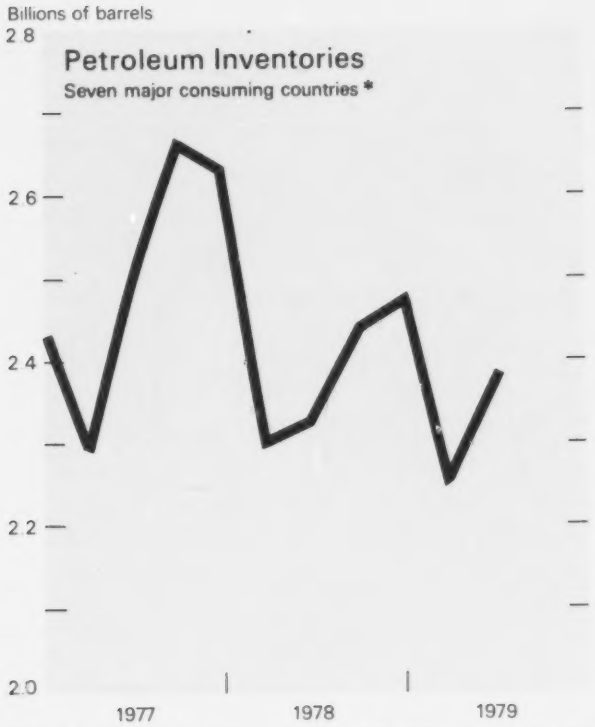
In the U.S., to be sure, the oil situation appears to have been somewhat tighter than in other countries. In addition to temporary squeezes on the availability of crude oil, oil supplies in the U.S. were affected importantly by the Administration's decision last March to request U.S. oil companies to refrain from bidding for oil in spot markets. Its objective at the time was to minimize upward pressure on spot prices and thus to reduce the incentive that high spot prices might have given OPEC to aim for additional increases in official prices. Spot prices and later official prices rose sharply anyway, but the absence during the early months of the year of U.S. companies from the spot market —a market that was growing in importance— probably reduced somewhat the U.S. share of available crude supplies. In addition, U.S. output of crude oil was declining. The shortfall in supply was greater in the U.S., thus, than it was, on average, in other importing countries.

A second key influence on supplies was tightness in U.S. gasoline refining capacity. This had been evident even in 1978 when crude supplies were plentiful: gasoline supplies, nevertheless, were relatively tight and inventories were low. The problem can be traced in part to price-control regulations specifying for the past several years what margin refiners could earn on gasoline sales—a rule which made the construction of increased gasoline refining capacity relatively unattractive. At the same time, the federal government was mandating the phase-out of lead as an additive in gasoline. Lead is used as an octane booster, and the reduction in the



lead content of U.S. gasoline supplies lowered the effective gasoline production capacity of U.S. refiners. The cutback in Iranian output further aggravated the problem since increased crude output of other OPEC countries—i.e., the output that offset the drop in Iranian output—was mainly "heavier" crudes from which less gasoline could be produced.

Even though it now appears that, at most, only a modest consumption cutback was required, that certainly does not mean that a policy aimed at achieving a modest cutback would have been a wise one at the time. In the spring, U.S. heating oil stocks were at very low levels and, although Iranian production had been restored to more normal levels, there was considerable uncertainty as to whether Iranian output would continue at the higher level. In this environment, the obvious policy response was to restrict gasoline consumption, particularly during the peak summer driving season, and to



*U.S., Japan, France, Germany, Italy, Netherlands, U.K. Excludes U.S. strategic petroleum reserve.

build heating oil stocks to ensure that adequate heating oil supplies would be available this winter even if the crude-oil supply situation deteriorated once again. To this end, the Department of Energy ordered refiners to shift their output mix toward heating oil (this policy was reversed when the gasoline lines hit harder than the government had anticipated) and it set high heating oil inventory targets for refiners.

The Administration was not alone in following a policy of inventory building. Faced with supply uncertainty and rising prices, industrial and other users of oil products no doubt attempted to boost their inventories to assure adequate supplies later in the year. Although such actions appeared rational in the face of the increased risks surrounding crude supplies, and were desirable from the point of view of the country as a whole, they did reduce the amount of oil available for a time. In effect, a shortfall of oil available for consumption was caused not so much by a shortfall of crude-oil production as by increased demand for inventory building as a result both of explicit government policies and of private decisions made in an environment of supply uncertainty and rising prices.

The basic problem that created the gasoline lines of May and June was that the existing allocation and price-control system provided no means of achieving even a modest reduction in gasoline demand. If gasoline had been sold in a free market environment, the price would have risen sharply (as it did in international spot markets), reducing consumption by the desired amount. With price controls in effect, however, this mechanism was not available. Gasoline prices had only risen from 67 cents per gallon late last year to about 75 cents when the gasoline lines first hit in California. With prices constrained as a method of reducing the quantity demanded and no rationing plan in place, demand for gasoline was beyond the control of either government policy or market forces.

To be sure, prices have since risen to close to $1.00 per gallon as a result of further OPEC price increases and regulatory changes by the Energy Department that permitted refiners and retailers larger margins on gasoline sales. Recent gasoline consumption data, furthermore, suggest that demand for gasoline has been significantly reduced by these price increases. The problem was that the depressing effect on demand of today's higher prices was needed in the spring and early summer when future crude supplies were uncertain.

Government policy was, however, singularly successful in reducing the supply of gasoline available for consumption, not only directly through requests for shifts in refinery yields and inventory levels, but also indirectly through the

allocation system. The allocation system serves as a substitute for the price system in distributing gasoline supplies to individual wholesalers and retailers. Allocations are based on patterns of gasoline distribution in the past and, therefore, cannot reflect current shifts in patterns of use. Consequently, the distribution of supplies will not fit exactly the actual distribution of demand and, even with adequate total supplies, local shortages can develop. Furthermore, certain "priority" users of gasoline were guaranteed all the supply they required and each state was allocated 5% of over-all supply to distribute as it saw fit. In some cases, state governments and priority users added these supplies to inventory, further restricting supplies available to individual consumers of gasoline.

With government policy aimed at reducing the supply of gasoline available for consumption, with private users attemping to build inventories, and with the allocation system inefficiently distributing product supplies—at the time when crude supplies were tight and consumption of gasoline was unconstrained by either price or explicit rationing—the stage was set for the gasoline lines.

The response of consumers to the first sign of lines at the gas pumps made inevitable the problems that followed. The response of drivers (first in California and later on the East Coast) was to "top off" their tanks. This behavior not only added to the lines at pumps (the average purchase of gasoline in Los Angeles declined from eight gallons to three gallons) but also put further strain on over-all supplies. It requires 12 million barrels of gasoline to add just five gallons to the tank of each car in the country. Although this figure is relatively low compared with the over 200 million barrels in refiner and wholesale inventories, it represents 5% of a typical month's consumption. With an allocation system in force that does not permit such a transfer of stocks from refiners to the tanks of automobiles, an extra 5% added to demand was enough to create the appearance, at least, of severe shortages of gasoline.

Source of the problem

The culprit in the episode was ultimately a government regulatory structure that was able to control supply but had only limited power to affect demand. Faced with the need to reduce gasoline consumption to assure adequate heating oil supplies next winter, and also to reduce pressure on international oil markets in the hope of heading off further OPEC price increases, policy was set to do the only thing it could—restrict supply. Demand, however, remained unconstrained. By default, the gasoline lines developed, serving as an unofficial "rationing" technique to bring demand into line with the available supply.

Although there is evidence that the allocation system led to an unnecessarily sharp reduction in the supply available for consumption, the key problem remains the absence of a market system that can efficiently and quickly adjust demand to the desired level.

Given the heavy dependence of this country on foreign oil (45% of U.S. oil supplies are imported), any disruption in the years ahead in international crude shipments obviously would bring major repercussions for industry and consumers. Change in the present distribution system would not, of course, alter that hard fact. But it would help the nation to ease the disruptions rather than to aggravate them as the existing distribution system did during the Iranian production cutbacks.

The U.S. Travel "Gap" Narrows

WITH all the attention that has been devoted to the impact of the gasoline situation on domestic travel patterns this year, it has been little noted that the U.S. is enjoying another strong year of foreign tourism. Travelers from many lands are arriving in record numbers—continuing a trend that has brought an impressive increase in foreign visitors in recent years. Last year 19.8 million foreigners came to the U.S., a gain of more than 50% since 1972.

Americans, meanwhile, have lost some of their former enthusiasm for foreign travel. The annual U.S. exodus to other countries—on the uptrend during the Sixties and early Seventies—peaked in 1973 at over 24 million and has since subsided.

These changing travel patterns are attributable importantly to the U.S. dollar's depreciation against a number of other currencies since earlier in the decade. This, of course, has made travel in the U.S. relatively less expensive than in earlier years for visitors from Japan and a number of European countries against whose currencies the decline in the dollar has been especially steep. And it has made travel to those countries relatively more expensive for Americans. Similarly, until the past two years, the Canadian dollar had been relatively strong against the U.S. dollar—encouraging an ever growing number of Canadians to come to the U.S. and discouraging American visits north of the border. Since the U.S. and Canada are each other's leading travel partners, flows between the two countries have been a particularly significant factor in the narrowing that has occurred in recent years in the chronic U.S. travel deficit.

Having widened rapidly during the latter half of the Sixties and early Seventies to a record $3.3 billion in 1972, the U.S. travel "gap"—the difference between what Americans spend in other countries and pay to foreign passenger carriers and what visitors spend in this country and pay to U.S. carriers—narrowed to $2.9 billion last year. While this $400-million contraction is but a modest improvement, the turn in the over-all travel deficit from its former growth pattern is welcome in view of this country's need to strengthen its international payments position.

Significantly, the gap between what Americans spend abroad for such things as food and lodging and what foreigners spend in the U.S. has narrowed much more sharply than has the over-all travel deficit (including net transporta-

Changing Trends in U.S. Travel Payments and Receipts

(Millions of dollars)

	1965	*1973*	*1978*
Payments of U.S. travelers in foreign countries	2,438	5,042	8,475
U.S. payments to foreign carriers	720	1,596	2,922
Total travel and passenger-fare payments	3,158	6,638	11,397
Receipts from foreign visitors in the U.S.	1,380	2,817	7,284
Receipts of U.S. carriers from foreign visitors	165	494	1,218
Total travel and passenger-fare receipts	1,545	3,311	8,502
Net U.S. travelers' payments	1,058	2,225	1,191
Net U.S. passenger-fare payments	555	1,102	1,704
Net U.S. travel and passenger-fare payments	1,613	3,327	2,895

tion payments). This gap has decreased by $1 billion during the 1972-78 period; but, as the table on page 7 shows, the contraction in this part of the accounts has been offset in large part by a $600-million increase in the passenger-fare deficit. As a result, net transportation payments now account for more than half of the over-all travel deficit. For a variety of reasons, foreign visitors are more likely to take a foreign carrier to the U.S. than Americans are to take a U.S. carrier abroad.

Although visitors from Canada and Mexico greatly outnumber those from any other country, the influx from Europe, Japan, and other overseas areas has been much more dramatic in percentage terms, having doubled since 1972 to 5.8 million last year (table on this page). More than two fifths of travelers arriving in 1978 from overseas—that is, from countries other than Canada and Mexico—came from Europe; about a fourth from the Caribbean, Central America, and South America; and roughly a third from the rest of the world, with Japanese visitors representing 15% of all arrivals from overseas areas. The great majority of visitors from overseas—80%—came on pleasure trips.

The growing popularity of the U.S. as a tourist destination is, as noted, partly attributable to the two devaluations of the U.S. dollar in December 1971 and February 1973. From 1973 through 1978, the dollar was in real terms some 17% to 21% cheaper on an annual average basis than in 1971,* making travel in this country a better "buy" for visitors from many nations. The depreciation of the U.S. dollar against European currencies and the yen, moreover, was even greater than that against a basket

*Calculations based on this bank's index of the real exchange rate of the U.S. dollar. That index is a measure of the dollar's trade-weighted average appreciation or depreciation vis-à-vis the currencies of fifteen other countries, adjusted for inflation differentials.

Visitors from Canada, Mexico, and Top 10 Overseas Tourist Sources

(Arrivals in thousands)

	1972	*1978*	*Percent increase*
Total	13,057	**19,842**	52
Canada	8,818	**11,939**	35
Mexico	1,377	**2,142**	56
Overseas total	2,862	**5,761**	101
Japan	417	**886**	112
United Kingdom	389	**757**	95
Germany	237	**486**	105
Venezuela	72	**304**	322
France	155	**260**	68
Australia	90	**179**	99
Italy	111	**153**	38
Netherlands	62	**141**	127
Bahamas	104	**133**	28
Switzerland	48	**122**	154

of key currencies that includes the Canadian dollar. With the U.S. dollar at a low point last year against European and Japanese currencies, visitors from outside North America posted the strongest increase of the 1972-78 period (28%), paced by especially strong gains in the number of travelers from South America (35%) and Europe (32%). The dollar's depreciation against key European currencies made the choice of the U.S. as a vacation site more attractive to South Americans and other visitors. European visitors had the additional stimulus last year of bargain air fares on the North Atlantic route. And discounts offered by U.S. air carriers for travel in this country—a result of deregulation of the airline industry in 1977—may also have helped draw visitors.

Meanwhile, Americans' travel to Europe and the Mediterranean, typically the destination of

about half of U.S. travelers heading overseas, has been decidedly off in recent years. Departures for most Western European countries peaked in 1972 or 1973 and dropped sharply in the subsequent few years—doubtless reflecting not only the effects of the especially large decline in the external value of the U.S. dollar that had occurred but also the effects of the most pronounced U.S. recession of the postwar period. Since 1975, departures to Europe again have risen, but the number of U.S. travelers to most countries except the United Kingdom and Ireland remained in 1978 well below the earlier peaks. In contrast, American travel to the Caribbean and Central America, South America, and other overseas areas has been stronger in recent years than earlier in the decade.

Not surprisingly, with rising costs of travel in Europe, Americans have been taking shorter trips. The average stay in Europe and the Mediterranean dropped from 27 days in 1973 to 20 days last year. Even so, average expenditures in the area have risen from $509 to $717 during the period—indicating that average spending per day has almost doubled from $19 to $36.

With a surge in receipts from overseas visitors between 1972 and 1978 and a slower rate of increase in U.S. travelers' expenditures, the U.S. gap with overseas countries collectively decreased by $330 million (table on this page). Among underlying trends of note: the deficit with Western Europe, which had doubled between 1965 and 1972, was virtually unchanged between 1972 and 1978; the gap with the Caribbean and Central America increased $220 million; and small surpluses with Japan and South America each increased by $300 million.

Travel between the U.S. and Mexico, as the table shows, has resulted in an increase of about $250 million in this country's travel deficit with Mexico. While visitors from that country rose a substantial 56% through 1975 (excluding border traffic), the inflow subsequently abated and last year's arrivals were a bit below the 1975 level. The fall-off doubtless reflects to some extent the peso's devaluation late in 1976, and its subsequent depreciation against the U.S. dollar. The peso has been virtually stable vis-à-vis the dollar since early 1977, but the earlier devaluation and depreciation have made travel in the U.S. more expensive for Mexican visitors. Conversely, the more favorable exchange rate for Americans traveling in Mexico probably has played a part in the recovery of U.S. departures in the past two years from a four-year low in 1976.

The striking turnaround in the U.S. balance with Canada—from a deficit of $100 million to a surplus of over $800 million—reflects a dramatic shift in visiting patterns between the two countries, together with higher per-capita expenditures by Canadians in this country than by U.S. visitors to the Dominion. Traditionally, U.S. travelers to Canada have substantially outnumbered Canadian visitors to the U.S., but in

How the U.S. Travel Balance Has Evolved

(Millions of dollars, excluding transportation)

	1972	*1978*
Deficit with all areas	−2,225	−1,191
Canada	− 109	+ 841
Mexico	− 415	− 662
Overseas	−1,701	−1,370
Western Europe	−1,193	−1,237
Caribbean and Central America	− 335	− 556
South America	+ 61	+ 369
Japan	+ 84	+ 387
All other areas	− 318	− 333

recent years the trends have converged—so that in 1977 and 1978 the number of visitors each way was virtually the same (the count excludes border traffic). The convergence was partly attributable to a relatively faster increase in prices for travel-related services in Canada than in the U.S. during 1975 and 1976, and the price effect was accentuated by the Canadian dollar's appreciation against the U.S. dollar during most of the latter year. Moreover, Canadians' real incomes grew more rapidly than U.S. incomes during the first part of the decade, and this appears to have influenced travel patterns (which lag income changes) during the following few years. However, with the Canadian dollar having depreciated against the U.S. dollar during 1977 and 1978, the relative cost advantage of the U.S. has been eliminated. As the Bank of Canada noted in its July *Review*: "Canada would now appear to be in a more favorable competitive position in travel than at any time in the past several years." And, in fact, a turn occurred in 1978, as Canadian visits to the U.S. declined slightly from the 1977 level.

Trends in 1979

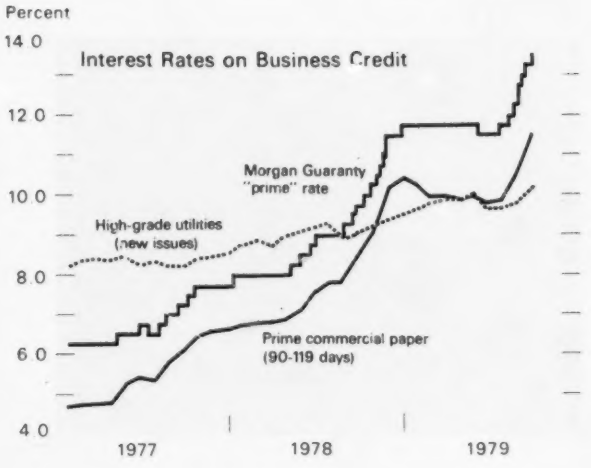
The decline has continued this year, with Canadian visits down about 5% in the first six months compared with the same period last year. Besides the Canadian dollar's continuing weakness against the U.S. dollar, the new trend appears to reflect in part U.S. gasoline shortages earlier in the year and the increased availability of discount air fares for travel within Canada (formerly quite limited). U.S. travel to Canada was off 2% in the first six months.

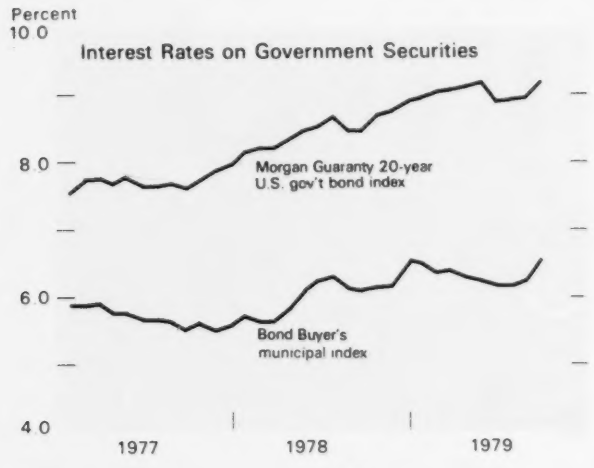
In contrast, travel between the U.S. and Mexico appears to be up in both directions this year. Although data on land travel lag some time behind events, air travel reports for the first quarter (the latest data available) indicate a 27% gain in Mexican visitors over the same period a year ago and a 12% increase in U.S. departures. Mexicans' real disposable income is rising rapidly and this, together with relatively lower prices in the U.S., is expected to stimulate visits to this country.

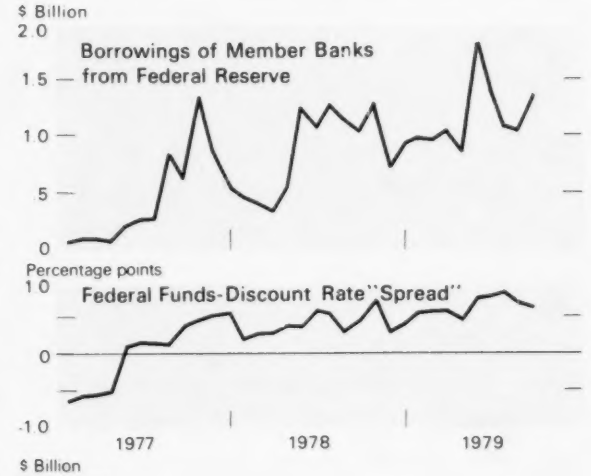
Visitors from overseas continue to arrive at a good clip, as more and more they have come to view travel in the U.S. as relatively inexpensive. The number of air travelers from Europe was up 25% in the first quarter over the same period last year, and the number from Japan and South America up 20% and 25%, respectively. In contrast, U.S. travelers to Europe were down 2% in the first quarter.

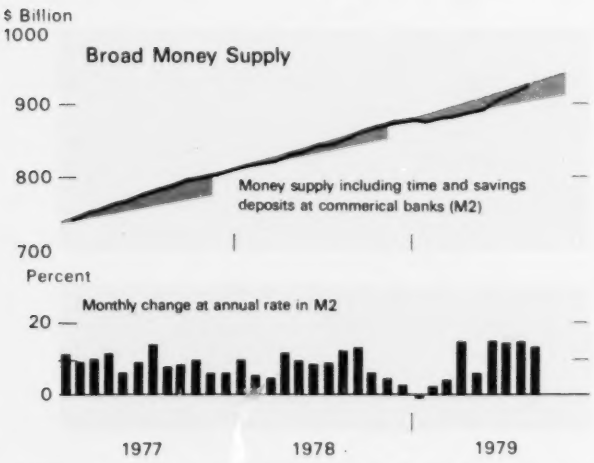
How the U.S. travel deficit will turn out this year is as yet unclear. Preliminary figures for receipts and payments (excluding passenger fares) in the first half, however, suggest that the improvement of the past several years is continuing—with the deficit, on a seasonally adjusted basis, 3% lower than in the first half of last year. If the deficit for the year as a whole decreases only slightly, or even remains stable, that would still represent progress. At a minimum, such an outcome would confirm that there has been a marked change from the earlier pattern of growth in the travel deficit. And, at the same time, it would point up the possibility of substantial improvement in the future in a significant component of the U.S. balance on current account. The possibilities for improvement in the travel gap are indeed wide open—with both the revolution in low-cost air transportation and growing appreciation abroad of the relative travel bargains that exist in the U.S. coinciding with increased prosperity in many industrial countries. Particularly promising for the U.S. travel gap in the longer run is that the market is vast and remains largely untapped.

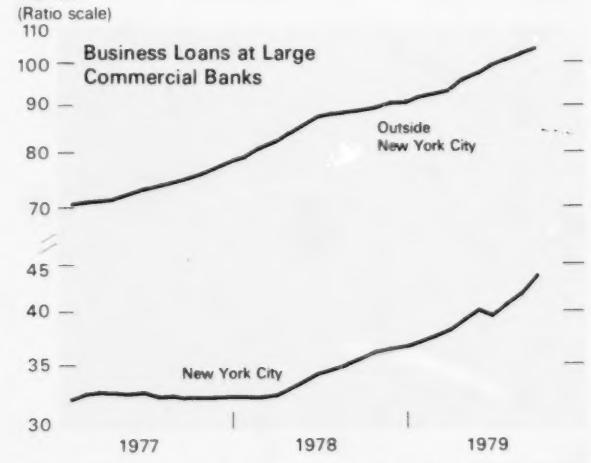
MONETARY INDICATORS











NOTE: Latest plotting in each chart is for the month of September; plottings for the money supply and business loans at large commercial banks are estimates. Business loans are net of bankers' acceptances and of commercial paper held by banks. All data except interest rates are seasonally adjusted. Shaded areas on money-supply chart represent the latest Federal Reserve long-run growth targets and comparable targets one and two years earlier.

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